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Why USD Fixed Income may look increasingly attractive to European investors

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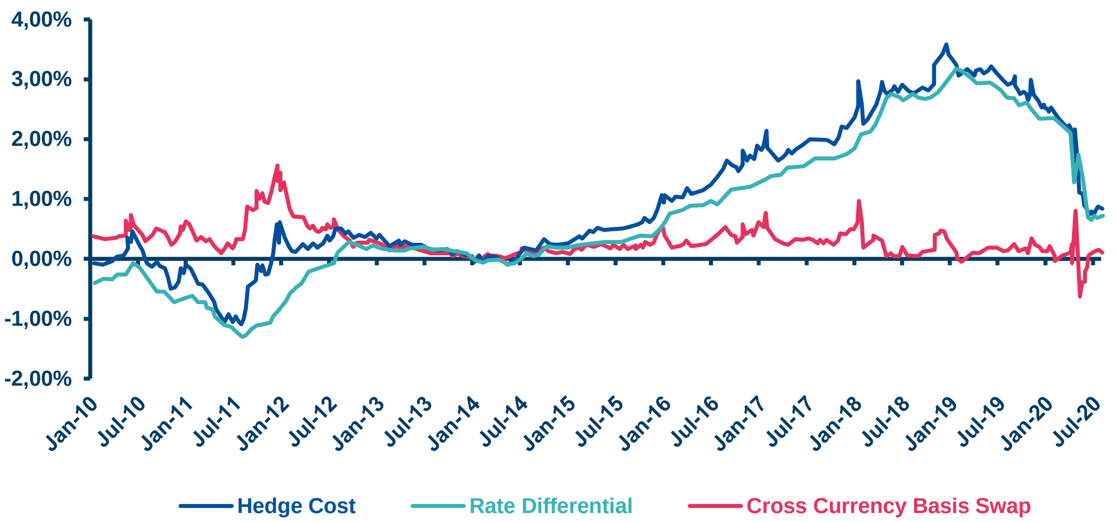
- *US fixed income can be a valuable source of diversification for European investors, but in the past the cost of hedging of the US Dollar exposure was high, neutralizing this benefit. The situation has changed, and the cost of hedging for Euro-based investors is much lower than in the recent past. Furthermore, we expect this cost will remain low.*
- *As a result, we believe the US market can potentially be a compelling investment opportunity for Euro-based investors to complement their domestic fixed income allocation with US bonds.*

The cost of hedging has significantly decreased

For a European investor, the cost to hedge US Dollar (USD) assets to Euros (EUR) has fallen -2.79% from a lofty peak of 3.64% near the end of 2018 to approximately 0.85%, as of June 27. (see Exhibit 1). This is certainly quite a material change in cost. What is driving the change? The primary driver of an investor's hedge cost is interest rate differentials, which are strongly impacted by Central Bank policies. In late 2014, interest rate differentials – and hedge costs – started to increase as the Federal Reserve Board starting hiking rates from the zero level. As the Fed shifted to a more accommodative monetary policy in the second half of 2018, interest rate differentials – and hedge costs – started to decrease. This trend significantly accelerated recently as the Fed cut rates and implemented programs to improve liquidity in short-term maturity markets to combat the market's reaction to the COVID-19 pandemic. The other factor influencing the cost of hedging is the premium to swap into USD. This premium, as expressed through the cross currency basis swaps, has also decreased since hedge costs were at peak levels.

Exhibit 1: Hedging costs for a Euro-based investor have decreased from over 3.6% to approximately 85 bps.



Source: Bloomberg. Notes: Hedge cost based on 3-month currency forwards. Cross currency basis swaps shown as premiums for USD. Hedge cost high was on November 14, 2018. Last data point June 25, 2020.

We expect hedging costs to remain range bound near recent low levels

USD-EUR and USD-GBP (Great British Pound) hedging costs should remain stable near recent levels and, we believe, are not likely to rise above 1% until 2022. There is a fundamental factor and a technical factor behind our benign hedging cost outlook. The fundamental factor that should serve as an anchor for US interest rates is the extremely dovish stance by the Federal Reserve Board. Following the June Federal Open Market Committee meeting, the Fed indicated that rates are likely to remain at current levels through 2022. Underpinning the dovish rate outlook is the Fed's cautious economic view that it will take a long time for the US labor market to recover from the impact of the COVID-19 pandemic. The technical factor is that the Fed's aggressive Quantitative Easing (QE) program remains open-ended and flexible, which will help keep a lid on US interest rates.

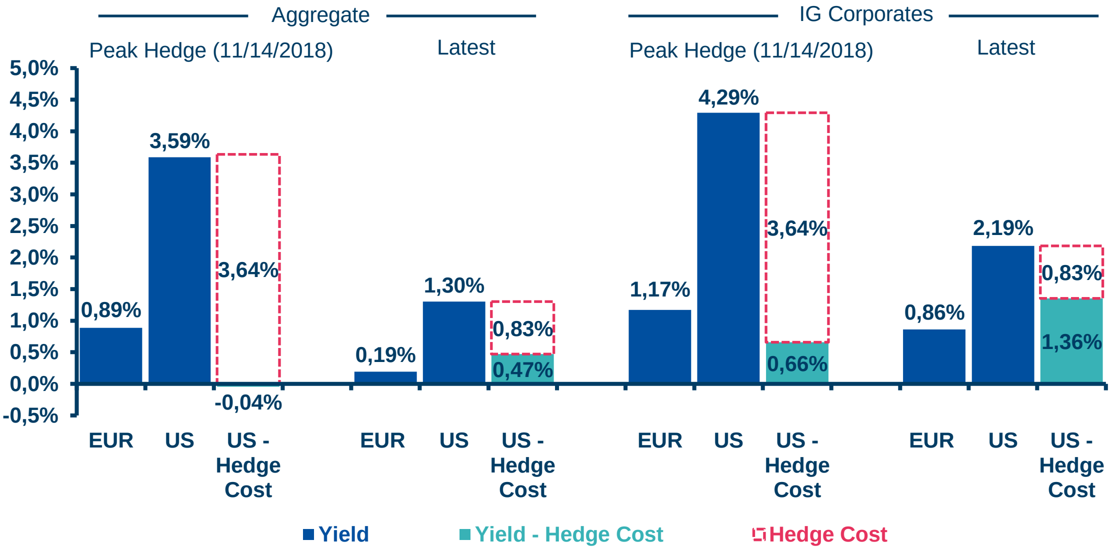
At the same time, rates are likely to remain unchanged for the European Central Bank (ECB) and the Bank of England (BoE). Both central banks have also embarked on QE. The ECB has also expanded Targeted Long Term Refinancing Operations (TLTRO) to keep credit flowing to Eurozone companies. This is likely to keep interest rates at the ECB and BoE low next year.

However, we think hedge costs could narrow further. In 2021, economic growth is expected to rebound more sharply in the EU and UK, at 5.5% and 5.8% respectively, compared to the US, which is expected to grow 4.1%, according to a recent Bloomberg consensus forecast. While it is not our base case that the ECB will exit its Negative Interest Rate Policy (NIRP), which it first implemented in 2014, the markets may begin to anticipate a policy shift towards zero if stronger macroeconomic numbers start to emerge later this year and in the first half of 2021. If forward-looking markets begin to price in a gradual move to zero, this could lead to a further decline in hedging costs, perhaps to zero next year.

The US market is a potential total return opportunity for the European investor

Despite the recent fall in US interest rates, US yields are still significantly higher than Europe-based yields. For example, the Bloomberg Barclays US Aggregate Bond Index yielded 1.30% as of June 25 and the Bloomberg Barclays Euro-Aggregate Bond Index yielded 0.19%, for a 1.11% yield advantage. Within Investment Grade Corporates, the Bloomberg Barclays US Corporate Bond Index yielded 2.19% on June 25 and the Bloomberg Barclays Euro-Aggregate Corporate Index yielded 0.86%, for a 1.33% yield advantage. These yield advantages more than offset the recent cost of a 3-month currency hedge, which was not the case when hedge costs were at peak levels near the end of 2018 (see Exhibit 2).

Exhibit 2: US Yields still higher than European yields after hedging costs



Source: Bloomberg, Amundi calculations Note: Hedge cost based on 3-month currency forwards. Last data point June 25, 2020. Aggregate compares Bloomberg Barclays US Aggregate Bond Index vs. Bloomberg Barclays Euro-Aggregate Bond Index. IG Corporate compares Bloomberg Barclays US Corporate Bond Index vs. Bloomberg Barclays Euro-Aggregate Corporate Index.

When we decompose US and Euro Corporate yields into their two primary components -- sovereign yields and credit spreads -- we believe that both components could provide tailwinds for the US market. US Treasury rates are much higher than European government rates, which are still stuck in negative territory. For example, the US Treasury 5-year yields were 0.33% on June 25, while the German 5-year yields were -0.70%, resulting in a 1.03% difference. Compression between interest rates will benefit a US investor compared to a Euro investor. As noted earlier, a scenario where European growth rebounds faster than US growth in 2021 and the market starts anticipating an eventual ECB exit from NIRP could be a catalyst for interest rate compression.

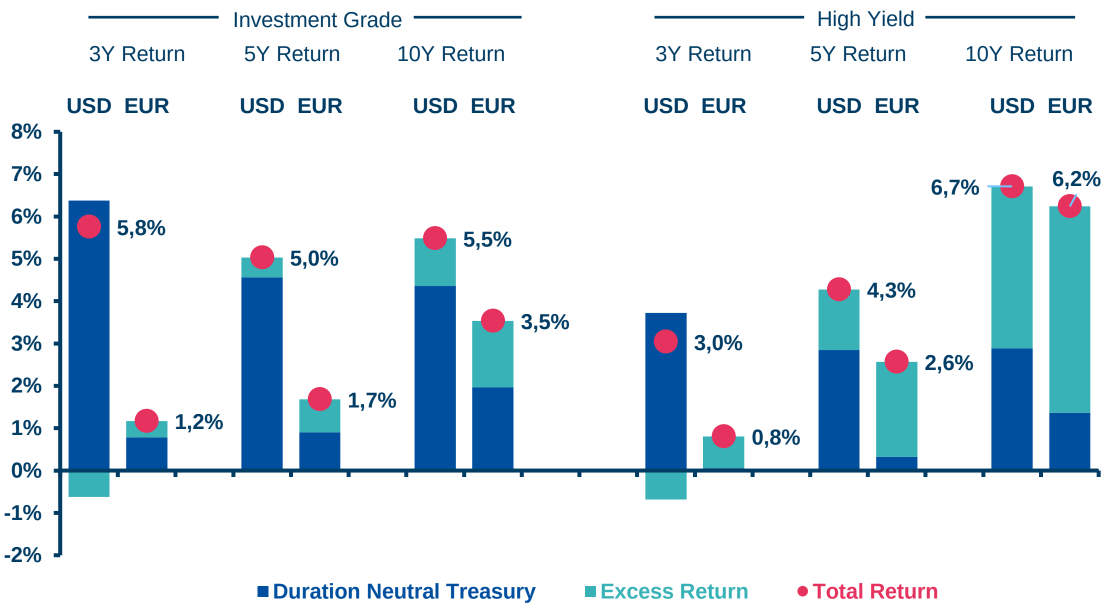
"Since the Fed is starting to follow the ECB's example in terms of policies, the US corporate market could benefit as the European market already has."

A historical look back on Investment Grade Corporate returns (see Exhibit 3) indicates that while US interest rate exposure has been a relative benefit to a European investor, US credit risk not been so favorable, generally lagging Europe. That said, there is the potential for this trend to reverse. Credit spreads in the US are generally higher than the Europe market after considering differences in credit ratings. We believe that one reason why this is the case is the prolonged support that the ECB corporate bond purchase program has given the European corporate market. Since the Fed is starting to follow the ECB's example in terms of policies, the US corporate market could benefit as the European market already has.

Further US spread compression likely

We believe the Fed will remain instrumental in helping to drive credit spreads lower. We see two ways this might happen. First, a convergence of Fed and ECB interest rates would lead to a continued quest for higher yields. Second, the Fed launched the Secondary Market Corporate Credit Facility (SMCCF) on June 15, which is an expansion of its QE program that includes purchases of corporate ETFs and individual bonds. This program should have the same favorable impact as it did in Europe with a further compression in spreads. Following the recent implementation of this program, we expect steady continued outperformance of US spreads versus Europe in the coming months. We see the added benefit of SMCCF potentially lifting performance across the spectrum of credit quality in the medium term.

Exhibit 3: Returns for the US and Euro Corporate Markets, Treasury and Credit-Related



Source: Bloomberg, Amundi calculations. Data includes 3-year, 5-year, and 10-year time periods ending May 29, 2020. Indexes used include Bloomberg Barclays US Corporate Bond Index, Bloomberg Barclays Euro-Aggregate Corporate Index, Bloomberg Barclays US Corporate High Yield Bond Index, Bloomberg Barclays Euro High Yield Index. **Past performance is not guarantee of future results.**

The US market can potentially help reduce portfolio level risk

"EU and US fixed income markets are not perfectly correlated, and therefore, European investors who allocate a portion of their capital to US markets may be able to improve their investment portfolio volatility profile."

Lastly, given the relatively low yields across sectors, we believe that investors should not only seek yield-enhancing strategies to improve return potential, but should also increasingly seek characteristics that help reduce or limit portfolio risk. US and European fixed income markets have different sector exposure levels and varying degrees of sensitivities to economic, geopolitical, and regulatory changes. As a result, the two markets are not perfectly correlated, and therefore, European investors who allocate a portion of their capital to US markets may be able to improve their investment portfolio volatility profile (see Exhibit 4). Moreover, the US market tends to be more liquid than the Euro market, which is another factor that leads us to believe the US market is relatively attractive right now to European markets.

Exhibit 4: Historical correlations and volatility of EUR-USD fixed-income Indexes

	Aggregate			Investment Grade			High Yield		
	EUR	USD	70/30%	EUR	USD	70/30%	EUR	USD	70/30%
3 Year									
Return	2.42%	5.07%	3.21%	1.17%	5.76%	2.55%	0.81%	3.04%	1.48%
Volatility	3.53%	3.28%	3.20%	5.07%	6.50%	5.34%	9.51%	8.72%	9.18%
Correlation			0.64			0.88			0.95
5 Year									
Return	2.11%	3.94%	2.66%	1.68%	5.03%	2.68%	2.57%	4.27%	3.08%
Volatility	3.62%	3.14%	3.25%	4.40%	5.64%	4.60%	8.08%	7.93%	7.90%
Correlation			0.68			0.85			0.92
10 Year									
Return	3.75%	3.92%	3.80%	3.53%	5.49%	4.12%	6.24%	6.71%	6.38%
Volatility	3.68%	2.97%	3.22%	4.05%	4.99%	4.13%	8.10%	7.00%	7.60%
Correlation			0.64			0.80			0.89

Source: Bloomberg, Amundi calculations. Data includes 3-year, 5-year, and 10-year time periods ending May 29, 2020. The historical returns for US Agg and US Corporate are unhedged. The statistics assume monthly rebalancing and a 70% EUR and 30% USD mix. Indexes used include Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays Euro-Aggregate Bond Index, Bloomberg Barclays US Corporate Bond Index, Bloomberg Barclays Euro-Aggregate Corporate Index, Bloomberg Barclays US Corporate High Yield Bond Index, Bloomberg Barclays Euro High Yield Index. **Past performance is not guarantee of future results.**

Conclusion

With the prospect of an accommodative Fed holding rates consistently low for the foreseeable future, the fundamental backdrop remains constructive for yield compression of US spreads to Europe. With the sharp decline in hedging costs since the end of 2018, and our expectation they will remain contained, we strongly believe US fixed income remains potentially attractive for foreign investors, especially European investors.

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Important Information

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